

# INTERNATIONAL GOVERNANCE

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## The IMF's Return to Iraq

Robert Looney

*The International Monetary Fund has imposed its traditional policies in Iraq. Few have considered the consequences. But the author notes that business as usual will probably not work in Iraq, and may well be destructive. He also wonders why there is so little imagination at the IMF.*

**D**ECEMBER 23, 2005, represented a landmark for Iraq. On that day, the Executive Board of the International Monetary Fund (IMF) approved that institution's first ever stand-by arrangement (SBA) for Iraq. The new arrangement is designed to support that nation's economic program over the subsequent fifteen months. The amount involved was 475.4 million Special Drawing Rights (SDR) (about US\$685 million). The SBA is expected to anchor macroeconomic policy during this fifteen-month interval.

The stand-by arrangement represents Iraq's second postwar loan from the IMF. The first was undertaken under the IMF's Emergency Post Conflict Assistance facility and was granted in September 2004 to assist Iraq's initial postwar recovery by supporting its economic programs through 2005. Just as importantly, the arrangement was

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also intended to facilitate Iraq's debt relief negotiations with its Paris Club creditors (mainly the advanced industrial countries). Approval of the stand-by agreement was a condition for a second stage of debt reduction agreed upon by the Paris Club.<sup>1</sup>

From these developments it is clear that Iraq is looking to the Fund to play an integral role in assisting its postwar recovery and eventual return to solvency and self-reliance. Yet few international organizations are as controversial as the IMF. To some, the IMF offers struggling countries the best means of reducing oppressive debt burdens while at the same time obtaining sufficient funds to sustain programs essential for sustained economic growth and development.

For others, the IMF, through its critical role in international debt reduction, represents neocolonialism at its worst. As a recent observer of the Iraqi case notes: "Post-Saddam Iraq offers a perfect illustration of how the industrialized world has used debt as a tool to force developing nations to surrender sovereignty over their economies."<sup>2</sup> And another observes:

The IMF's controversial strategy for aiding at-risk economies involves manipulating weak nations into privatization and "structural adjustment" plans favorable to foreign investors—in this case largely as a requirement of forgiving former dictator Saddam Hussein's considerable international debt. Social movements the world over broadly oppose such policies since they typically result in increased indebtedness and decreased living standards for the poor.<sup>3</sup>

Similar criticisms of the Fund's sister organization, the World Bank, have been advanced:

The World Bank has forced dozens of countries to put their economies in the hands of the "free market"—achieved by eliminating regulations and taxes and granting maximum flexibility to business and investors. Its insistence on limiting the reach of government, and creating new ways to apply free-market principles to economies unaccustomed to unbridled competition, has moved many observers to label it a leading advocate of "market fundamentalism"—the ideological belief that all economic problems can, and should, be solved with free-market solutions. Now the World Bank is bringing its doctrines to Iraq. The U.S. Government has acknowledged its concern that religious fun-

damentalists might gain power in Iraq, but it has no problem with the introduction of market fundamentalism.<sup>4</sup>

Are these valid concerns? Is Iraqi involvement with the Fund likely to bring more instability than stability to that troubled country? While it's impossible at this point to provide definitive answers to these questions, the sections below attempt to shed a little light on the issue by examining the Fund's initial efforts in Iraq.<sup>5</sup> In particular, are the Fund's loans and associated programs likely, despite limited Iraqi input and popular support, to provide the Iraqi economy with a framework capable of generating a recovery and eventually moving to sustained growth? If not, are there better alternatives?

## **The Policy Setting**

Rough pictures of the harsh environment in which the Fund's programs are being executed in Iraq are contained in that country's National Development Strategy (NDS). As the NDS notes, Saddam Hussein's economic legacy will be present for some time. In particular, that regime's disastrous economic policies, together with political repression, internal conflicts, wars, and sanctions, have left a number of serious impediments to recovery and growth. While some of these obstacles are lessening, thanks to the reforms put in place by the Coalition Provisional Authority (CPA),<sup>6</sup> others were created or reinforced through subsequent postwar policy errors and miscalculations.<sup>7</sup> The overall impact has been the creation of a number of serious structural constraints on growth and development.<sup>8</sup>

1. The oil sector dominates the economy, accounting for around 74 percent of gross domestic product (GDP). Iraq now depends solely on oil exports for finance of investment and consumption expenditures, for government revenues—of which oil export proceeds exceed 93 percent—and for 98 percent of foreign currency earnings.
2. Centralized decision-making and intrusion of the state into economic life have distorted the pricing structure in many sectors to the extent that prices often do not reflect the real value of

- the product or service. In turn, distorted prices have caused inefficiencies and waste.
3. The public sector is overrepresented in the economy, leading to inefficiency and decreased growth. Many state-owned enterprises (SOEs) are currently dormant. The weakness of the private sector has limited its role in economic development, increasing the lack of diversification.
  4. Social inequalities are widespread in a broad range of fields covering health, education, public services, social services to low-income groups, the disabled, internally displaced persons, refugees, single-parent households, and other vulnerable groups, across geographic areas.
  5. With over 50 percent of the population under twenty-four years of age, rapid rates of population growth are likely for many years. Many in this large demographic group are alienated due to violence and limited access to education, training, and career prospects.
  6. Widespread unemployment ranges up to 50 percent. In addition, more than 60 percent of the population depends on the government's rationed food basket. Unemployment has led to an increase in demands for social assistance.
  7. Poor governance practices are common, including widespread nepotism in public appointments and corruption among public servants. The lack of accountability and transparency in managing state resources has abetted corruption and increased its corrosive effect on growth and efficiency.
  8. Iraq's decades-long isolation has resulted in the digital divide, with outdated institutions, administrative systems, and know-how. Technological stagnation and the use of outmoded production methods have weakened the economy as a whole.
  9. Public-sector institutions have witnessed serious looting, theft, and destruction.
  10. The traditional family unit and the community have remained the core of Iraqi society, ensuring solidarity and social cohesion against all odds. However, conflict and inequality have

eroded the social fabric of communities and families throughout the past three decades.

11. In Iraq, social capital establishes an important relationship between incomes and human capability to withstand shocks. Iraqis have witnessed a depletion of social capital, which led to social deprivation in most sectors of society.
12. Civic participation and recognition of human rights were denied during the previous regime. They remain poorly understood and lack ancillary support structures.
13. A large informal economy coexists with the formal sector. This informal economy may account for as much as 65 percent of gross domestic product.<sup>9</sup> Even more worrisome is the large criminal element that controls large segments of the informal sector.<sup>10</sup>

A recent United Nations Development Programme (UNDP) household survey documents the impact these factors are having on the average Iraqi household:<sup>11</sup>

1. The UNDP survey suggests that the poorest 20 percent of the population earns 7 percent of the income, while the top 20 percent earns 44 percent.
2. Iraq's median household income of \$144 has dropped from a postwar high of \$255 in 2003.
3. One-third of Iraqis canvassed by UNDP described themselves as being among the poor.
4. One-sixth of interviewees met all or most of the criteria suggesting that they lived beneath the poverty line.

The IMF clearly recognizes the magnitude of the problem confronting it in Iraq. In fact, the Fund has stressed the difficulty of implanting policies in that country,<sup>12</sup> especially in light of the constraints imposed by the new, fragile, and very incomplete institutional setting,<sup>13</sup> the public sector's limited administrative capacity, and the precarious social, political, and security situation brought on by the ongoing insurgency. The real question is: Are the Fund's programs capable of alleviating many of the adverse factors currently afflicting

that country's economy? Rather than directly attacking the country's many structural constraints to growth and recovery, the Fund sees its main contribution in Iraq as one of supervising and facilitating the conduct of sound macroeconomic policy, leading eventually to debt relief through the Paris Club.

### **Issues Surrounding IMF Programs in Iraq**

While an original charter member of the Fund, the country had had little contact with the Washington-based organization during Saddam Hussein's reign. Iraq's initial steps at restoring its relationship with the IMF began in 2004. At that time, the interim government nominated a governor to represent the country at the Fund. Next Iraq settled its arrears to the Fund (SDR55.3 million), while also consenting to an increase in its Fund quota (raising it from SDR504.0 million to SDR1.188 billion). Steps were also taken to clear Iraq's arrears to the World Bank and the Arab Monetary Fund. Finally, the authorities began working with the country's other external creditors toward the resolution of its unsustainable external debt burden.<sup>14</sup>

With the groundwork laid, the Fund's initial role in Iraq's postwar setting took shape on November 21, 2004. At that time, in a major development on the debt front, the nineteen industrialized nations that comprise the so-called Paris Club agreed to write off a portion of Iraq's debt in three stages. The first 30 percent, amounting to \$11.6 billion, is to be written off unconditionally. A second 30 percent reduction will be delivered "as soon as a standard International Monetary Fund (IMF) program is approved." A final 20 percent reduction will be granted "upon completion of the last IMF board review of three years of implementation of standard IMF programs." In other words, 30 percent of Iraqi debt will be excused only if the IMF and Iraqi authorities agree on an economic "reform" package, and another 20 percent will be written off only if the Fund is satisfied that Iraq has implemented the terms of this package.<sup>15</sup>

As Paris Club members hold around \$40 billion in Iraqi debt, Iraq will still owe \$7.78 billion to the Paris Club even if the IMF certifies

its adherence to its specified conditionality requirements. If Iraq does not satisfy the Fund, it will owe \$27.16 billion to the group of nineteen industrialized nations.

### ***The Emergency Post Conflict Assistance (EPCA) Program***

As noted, a key element in the Paris Club accord was the stipulation of Iraq's undertaking and successfully completing a standard IMF program. Given the country's postwar state, together with the ongoing insurgency, the Fund's Emergency Post Conflict Assistance (EPCA) program seemed the most appropriate choice.

EPCA-type programs have an interesting history. In 1962 the IMF began providing emergency assistance to member countries afflicted by natural disasters such as floods, earthquakes, hurricanes, and droughts. This assistance is aimed at meeting immediate foreign exchange financing needs arising from, for example, shortfalls in export earnings or increased imports. A prime consideration underlying this type of loan is avoiding a serious depletion of external reserves.<sup>16</sup>

In 1995, the IMF's emergency assistance facility was expanded to cover countries in post-conflict situations. This assistance is limited to circumstances where a member with an urgent balance-of-payments need is unable to develop and implement a comprehensive economic program because its capacity has been damaged by a conflict, but where sufficient capacity for planning and policy implementation nevertheless exists. In these circumstances IMF financing can help a country directly with the infusion of funding and indirectly by catalyzing support from other sources.<sup>17</sup>

For its part, the Iraqi government pledged to develop a comprehensive economic and financial program with the Fund, stressing the need to:

1. Increase the price of petroleum products.
2. Make monetary policy more adaptable by widening the number of instruments for managing liquidity conditions.
3. Undertake structural reforms with regard to: (a) tax administration, (b) payments and settlements systems, (c) state-owned



enterprise restructuring, and (d) governance and transparency in the oil sector.<sup>18</sup>

The EPCA was difficult to implement and its progress hard to assess. In part these difficulties stemmed from the lack of accurate and timely statistical data. With these caveats in mind, the program produced mixed results. By the summer of 2005 the Fund was expressing concern over the slow pace of reform implementation and that the country was not strictly adhering to the terms of the EPCA. Specifically:

1. The IMF estimated GDP growth of about 50 percent in 2004, following several years of contraction. For 2005 the IMF estimated that growth slowed to around 2.6 percent (against an initial EPCA program target of 17 percent, which was later revised down to 3.7 percent) as a result of lower-than-expected oil production caused by the ongoing insurgency.
2. Inflation in 2004 was estimated at 20 percent against an EPCA target, with prices remaining volatile.
3. On the other hand, the fiscal deficit in 2005 was expected to be about half what was projected under the EPCA program. However, this would only occur if oil prices were higher than expected. Oil production remained flat at around 2.0 million barrels per day—approximately the average achieved in 2002.

From the Fund's perspective, the major area of deficiency under the EPCA program was the reluctance of Iraqi officials to increase domestic prices of refined oil products. Under the EPCA timeline, the Iraqi authorities were supposed to have begun the adjustment of domestic prices by the end of 2004. This did not occur, and by mid-2005, gasoline prices in the black market had risen to very high levels with the authorities continuing to supply gasoline locally at heavily subsidized prices—less than US\$0.02 per liter (US\$0.05 per U.S. gallon), one of the lowest prices in the world, even though local refineries were unable to keep up with demand. Prices were several times higher in neighboring oil states such as Kuwait and Iran, while the

price differential with Turkey may on occasion have been as much as ten times greater.

As might be imagined from elementary economic theory, the low price of gasoline produced both shortages and thriving black markets. To ease the shortages, Iraq, a country with the world's third largest crude oil reserves, spent US\$3.2 billion in 2004 on imports of petroleum products, mostly gasoline.<sup>19</sup> Ironically, much of the imported petroleum products had originated in Iraq only to be smuggled out of the country to take advantage of the Iraq/external price differential.

The cost of buying from neighboring countries is magnified by rampant export smuggling, with a steady stream of subsidized gasoline flowing back out of the same countries where the government bought it. Black-market fuel dealers, offering a faster alternative to queuing at the pumps, exploit the artificial price gap. The insurgency is also heavily involved in black market arbitrage. A gas station owner selling a tankerload of gasoline at the official price could expect to make about \$340 in profit, while selling the same gas on the black market would net more than \$4,800.<sup>20</sup> The resulting revenue loss in the government budget was as much as US\$8 billion or 30 percent of GDP in 2004.<sup>21</sup>

While the economic solution to smuggling and black markets is rather straightforward—simply let the price of gasoline be determined by market forces—there is considerable opposition to this in Iraq. Iraqis mired in poverty have become too dependent on cheap fuel, with many arguing that Saddam Hussein always produced enough gasoline to meet local demand, even during the thirteen-year period of UN-imposed sanctions.

Less obvious to many is the fact that since the overthrow of Saddam Hussein, dramatic shifts in fuel supply and demand have taken place. Fuel demand has risen at a much faster rate than anyone anticipated, whereas on the supply side refineries have been strapped by pipeline stoppages and electricity outages. There has also been an explosion of cars coming into the country. These have resulted in an estimated 1 million more vehicles on Iraqi roads. With the electricity grid down about half the time, home generators put a further drain on fuel

supplies. The rising use of air conditioners has only compounded the problem. Before the war, Iraqis used 4 million gallons of gasoline a day. By 2005 that number had surged to 6 million gallons a day.<sup>22</sup>

Under these circumstances, it would seem that only a new pricing strategy will help to curb wasteful fuel use, thus bringing supply and demand into balance.<sup>23</sup> There is little popular support in Iraq for this “economic” solution. Iraqi politicians always looking toward the next election are reluctant to touch gasoline prices, a basic welfare issue that could trump sectarian loyalties. A typical political response to proposed price increases is that fuel subsidies must be maintained “until the people’s financial situation is better.” To this the IMF would no doubt respond by pointing out that “damaging market distortions” caused by subsidies are at the root of Iraq’s economic problems, and there is no time like the present to liberalize the current system.<sup>24</sup>

The Iraqi government has tried to avoid price increases through various initiatives designed to decrease local consumption. One plan ordered drivers to leave their cars at home on alternating days based on odd- or even-numbered license plates. But as might be imagined, the rule was hard to enforce, with many drivers reportedly using two sets of plates and switching them daily to avoid the heavy noncompliance fine.<sup>25</sup>

Another attempt at a nonprice solution to the country’s fuel problems was the introduction of a ration card system. Such a system has been in operation for buying gasoline in Kirkuk and Iraqi Kurdistan for most of 2005. In September 2005, rationing was introduced in the rest of Iraq for the purchase of kerosene and cooking gas, using the existing food ration system. By October the use of ration cards had extended to the purchase of gasoline as well. This program also was unpopular, with the chief complaints that the coupons were not being equitably distributed, that “gangs” with connections to the Ministry of Oil officials were trading actively in the black market, that there were still long queues at petrol stations, and that the coupons were late in arriving.<sup>26</sup>

Finally toward the end of 2005, under pressure from the IMF and facing mounting opposition to nonprice solutions, the Iraqi cabinet

agreed to raise the price of petroleum and petroleum derivatives by between 100 percent and 200 percent. This would bring the price per liter for regular gasoline to 50 dinars and for refined gasoline to 150 dinars, in addition to price increases for other derivatives of white petroleum and liquefied gas.<sup>27</sup> This was meant to be the first in a series of increases over the course of 2006 designed to raise the price of fuel to the average in Persian Gulf states—about 93 cents per gallon.<sup>28</sup>

Although the decision to raise gas prices had been made in October, it was not announced until December 18, several days after the national election. In addition, the price increases went into effect immediately rather than in early January as originally planned. There were immediate protests across the country with several governorate councils—Basra, Karbala, Dhi Qar, and Maysan assemblies—declaring their intention to disregard the edict.

The price increase was greeted with general criticism from the media, with statements of support limited to some, but not all, of the papers associated with the ruling Unified Iraqi Coalition. The majority of sources indicated that the government had failed to provide a convincing account of why the increase was necessary.<sup>29</sup>

Finally, a December 22 statement from the Council of Ministers explained that the increase would reduce the costs of Iraq's international debts and fuel subsidies, while at the same time serving as a disincentive for smugglers. As Prime Minister Ibrahim al-Ja'fari noted: "We faced a tough decision. They [the IMF] are not willing to help a country that squanders its wealth, as they put it."<sup>30</sup> The Council assured that the extra revenue derived from the price increases would be used to support "a million poor families and the oil industry's infrastructure"—the added revenue from the sale of higher priced gasoline was to be put into a fund to assist very low-income families.

Clearly the fuel price increases were undertaken largely to qualify for the next phase of IMF lending. However, a very good economic case can be made that the price reforms were clearly in the government and country's best interest. A recent World Bank analysis of the country's domestic fuel markets concluded that black market prices

average ten to forty times above the official ones.<sup>31</sup> The Bank's econometric simulations suggested that a sixfold increase in fuel prices would lead to a 16 percent decline in fuel imports and a 30 percent decline in black market sales. Government savings would amount to about \$1.73 billion, allowing for additional investment or compensation to households.

However, the resistance met by the government's December 18, 2005, decision to increase fuel prices raises question about Baghdad's ability to undertake economic reforms in the face of popular and provincial opposition. That the government was not able to make a convincing case to the public on such an obviously beneficial policy raises serious doubts about the future of economic reform in Iraq and the ability of the IMF to assist in advancing the country's re-entry into the global economy.

### ***The Stand-By Loan***

Despite the difficulties encountered by the Iraqi authorities in pressing ahead with fuel price deregulation, a key aspect of the EPCA, the country received a favorable evaluation from the IMF. Takatoshi Kato, the Fund's deputy managing director, noted: "The Iraqi authorities were successful in promoting macroeconomic stability in 2005, despite the extremely difficult security environment."<sup>32</sup> As with all IMF programs, the stand-by arrangement signed on December 23, 2005, sets a number of performance criteria (see Table 1). These include:

1. A floor on net international reserves of the Central Bank of Iraq (CBI).
2. A ceiling on lending to the government and the private sector by the CBI.
3. A ceiling on the primary deficit of the government.
4. A ceiling on the government wage and pension bill.
5. A floor on the revenue of oil-related state-owned enterprises, including those remitted to the budget.
6. A ceiling on external arrears on new borrowing.

7. A ceiling on contracting and guaranteeing of new medium- and long-term concessional external debt.
8. A ceiling on government imports of petroleum products.

Ultimately, the success of the program rests on meeting the program's targets, which in turn depends in large part on favorable developments in the oil sector. If these conditions are met, the IMF anticipates an increase in economic growth in 2006, with a continuation in the reduction of inflation. As for the oil sector, after stalling at 2.10 million barrels per day (mbd) in 2005, it is hoped oil production will expand during 2006, reaching 2.3 mbd by the end of the year. If this occurs, non-oil economic growth may reach 8 percent, with overall GDP growth increasing from 2.6 percent in 2005 to 10.4 percent in 2006. The inflation rate is expected to fall to 15 percent by the end of 2006.

The IMF program envisions that the country's fiscal position will be driven by the ongoing reconstruction program, subject to financing constraint. As events have unfolded, the country's anticipated revenues have had to be revised numerous times. Despite the high degree of uncertainty over future sources of revenues, the Fund has an optimistic outlook, projecting the 2006 fiscal deficit at 8.2 percent of GDP following a deficit of 10.8 percent of GDP in 2005. For the medium term out to 2010, the Fund sees construction needs subsiding and the government's fiscal deficit gradually declining toward zero.

In the monetary area, the Fund sees a continuation of the de facto peg of the Iraqi dinar to the U.S. dollar. With the stipulation of the program's target of no net domestic credit creation, net international reserves of the Central Bank of Iraq (CBI) should continue to increase by some \$1.7 billion to \$10 billion by the end of 2006.

## **Assessment**

As in most developing countries, the Fund's role in Iraq has been controversial. It has been an easy target for critics' claims that its programs are more in the interest of the larger industrial countries than that of the host country. In Iraq's case, a variant of this theme

Table I

**Iraq: Quantitative Performance Criteria and Indicative Targets Under the IMF Stand-by Agreement, 2005–2006** (in billions of Iraqi dinars, unless otherwise indicated)

	2005	Performance criteria				Indicative target	
	9/30/05	12/3/05	3/31/05	6/30/06	9/30/06	12/31/06	
<i>Cumulative change from September 2005</i>							
Net international reserves of the CBI (floor; in millions of U.S. dollars)	8,500	-1,000	-1,000	-1,000	-1,000	-1,000	
Lending to the government and the private sector by the CBI (ceiling)	8,500	0	0	0	0	0	
<i>Cumulative flow from beginning of calendar year</i>							
Government primary fiscal deficit (ceiling; in billions; deficit [+]/surplus[-])		5,400	1,950	3,600	4,850	5,300	
Government wage and pension bill (ceiling)		6,650	2,400	4,750	7,100	9,500	
Revenue of oil-related enterprises, including those remitted to the budget (floor)		900	700	1,500	2,400	3,250	
New medium-and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling; in millions of U.S. dollars)		500	500	500	500	500	
External arrears on new borrowing (ceiling; in millions of U.S. dollars)		0	0	0	0	0	
<i>Indicative target</i>							
Government imports of petroleum products (ceiling)		6,000	1,700	3,400	4,000	4,200	

Notes: Derived from *Iraq: Request for Stand-by Arrangement* (Washington, DC: International Monetary Fund, January 2006), p. 45, table 1. Indicative targets are to be set as performance criteria in the context of the first review under the Stand-by Agreement. Flows for 12/31/05 are cumulative for 2005. Flows for 2006 are cumulative starting 1/1/2006.

Notes: Derived from Iraq: Request for Stand-by Arrangement (Washington, DC: International Monetary Fund, January 2006), p. 45, table I. Indicative targets are to be set as performance criteria in the context of the first review under the Stand-by Agreement. Flows for 12/31/05 are cumulative for 2005. Flows for 2006 are cumulative starting 1/1/2006.



suggests that “In their proposals to write off some of the debt, the Paris Club members took advantage of the opportunity to impose conditions that could bind the successor government in Baghdad to policies of free-market fundamentalism.”<sup>33</sup>

Another line of criticism contends that IMF-type programs stressing free markets, deregulation, and privatization are simply not appropriate for many countries, especially those going through a difficult transition. Nobel Prize winner Joseph Stiglitz has repeatedly stressed that when applied to countries like Russia in the 1990s, many programs similar to the ones introduced to Iraq have caused disastrous results—in the Russian case, a decline in GDP by 50 percent and an increase in the poverty level from 2 percent to more than 20 percent following the introduction of IMF programs.

Elsewhere Stiglitz has suggested that while, in theory, IMF supports democratic institutions in the nations it assists, in actual practice it often undermines this process through its policies.<sup>34</sup> In Iraq’s case, freeing fuel prices is arguably good economics, but it is not something an elected government wanted to do—certainly there was no grassroots support for such a shift in policy. The growing discontent in Iraq brought on by higher gas prices is only adding one more stress to an already fragile system.

Related to this is the timing of the stand-by agreement. This program was consummated without any input from a newly elected government. Yet this new government will have to meet its conditions and live with its consequences. All the Fund had to do was wait a month or so to deal directly with the new government. Most likely the chances of the stand-by agreement’s success would have increased if the new government had a direct input to the agreement. As Professor Feldman has noted, “The IMF or the World Bank are in a position to impose certain conditions. . . . [but] we have seen this throughout the world, that various decisions that the government needs to take tend to have more buy-in from the public if they are perceived as having been made domestically rather than imposed by the international organizations.”<sup>35</sup>

In sum, as is the situation in most of the countries in which it is



active, the IMF program is not based on popular support but instead relies on a small group of technocrats for its implementation. However, the Iraqi technocrats who negotiated the SBA may not be in a position to assist in implementing the program. There is every sign that the newly elected (December 2005) Shia-dominated government will not be receptive to the liberal economic blueprint advanced by the IMF. As a leading business publication noted: "We remain concerned that political interference and cronyism in Baghdad from the incoming Iraqi government could significantly 'crowd out' efforts by the very affluent expatriate Iraqi private sector to develop significant parts of the Iraqi economy because of bureaucracy and unnecessary involvement by the national government."<sup>36</sup>

Possible future legislation proposed by the Ministry of the Interior in a December 26, 2005, memo suggests a high likelihood that the new Iraqi government, should it survive, will pursue a course of action directly at odds with the IMF's intent to create a climate conducive to private domestic investment complemented by large flows of foreign direct investment (FDI). Specifically the ministry proposes:<sup>37</sup>

1. All contracts would be issued only to Iraqi contractors.
2. No international companies would be permitted to register in Iraq without proof of residency.
3. Restricted access of non-Iraqi international or Arabic-speaking people to Iraq.
4. Creation of a commission called the Investment Promotion Agency with responsibility for overseeing all foreign investment in Iraq, coordinated through nineteen government ministries.
5. No U.S. dollar accounts to be permitted in Iraq; all accounts to be in Iraqi dinars.
6. All ministry accounts to be centralized.

Clearly, security is one consideration behind these measures. However, each of these measures has the potential to be quite protectionist. If any or all are implemented, the outcome would likely lead to increasing opportunities for corruption and have a significantly nega-

tive impact on the economy's transition to a relatively free market environment.

The Iraqi trade unions are also advancing an agenda sharply at odds with the IMF. This group stresses that the policies of the IMF and World Bank in Iraq should:<sup>38</sup>

1. Increase transparency and provide representation for Iraq in the decision-making structures of International Financial Institutions.
2. Stop imposing structural adjustment conditions for loans.
3. Agree to provide funding for public services and state-owned enterprises without demanding their privatization.
4. Cancel debts owed by Iraq that have resulted from the policies of the former regime.
5. Reject the reduction of spending on social services, especially the elimination of government support for the food distribution system or the reduction in the number of items covered.
6. Strongly reject the privatization of publicly owned entities and especially of the oil, education, health, electricity, transportation, and construction sectors.
7. Adopt a new labor law and a pension and social security law that ensure workers' rights and are in conformity with international labor standards and human rights conventions. The World Bank and the IMF must also respect these standards.

While this program may be unrealistic considering Iraq's debt situation, it does convey a widespread popular sentiment that could quickly turn into broad-based resistance to the IMF's efforts in Iraq. In this case, the IMF might also lose international support, because it is clear there are alternative programs that have a much greater chance of succeeding in the Iraqi context.

One such program is the innovative oil fund approach put forward by Thomas Palley.<sup>39</sup> He has suggested that a fairly high percentage of Iraq's oil revenues be placed in a fund for direct distribution to the population. In addition to the obvious popularity of a direct distribution fund, its great strength lies in the prospect of the establishment of a virtuous circle of demand-led growth as opposed to the

current economic malaise or even by some accounts a vicious circle of unemployment, increased recruits into the insurgency, and further postponement of private-sector investment, followed by more unemployment. Most importantly, by breaking the direct link between oil and the government, this approach holds out the distinct prospect of enabling Iraq to avoid the oil curse that has plagued so many resource-rich developing countries.<sup>40</sup> In addition, there would be many tangible benefits associated with a disbursal program of this type, each of which can play an important role in the country's recovery:

1. The Iraqi people would have increased incentive to protect the country's oil facilities by providing intelligence on insurgent groups attempting to disrupt the production and flow of oil.<sup>41</sup>
2. It might even help stem the insurgency, especially if much of that activity is driven by Sunni fears that they will receive considerably less than their accustomed amount under the new constitution.
3. Men and women would receive equal distributions.
4. It would establish an irrevocable personal identity under the law—essential for establishing titled property rights, bank accounts, human rights protection, voter lists, and taxpayer lists.
5. It would expand banking and credit access for small and medium business.
6. It could help offset public resistance to gas price increases that will be needed to cut back oil smuggling. A related benefit is that it would also greatly help the government cut back on gas subsidies, which currently amount to billions of dollars a year.
7. Without equitable distribution of oil revenues, competition among various groups for oil money could turn ugly, and even erupt into violent conflict in Iraq. Rifts over oil revenues already run deep, as Iraqi Kurds, Arabs, and Turkmen struggle for control of oil-rich Kirkuk.<sup>42</sup>
8. Citizens eligible for fund payouts would have an incentive to

monitor the government and participate in the political process to guard the value of their entitlement.

9. A related effect is that oil funds are likely to encourage efficiency in the petroleum sector. Since the size of payments to citizens will depend on the efficiency of the oil industry, this should contribute to political pressure to improve efficiency.
10. Oil funds are expedient—rather than the long time intervals needed to improve government accountability and anti-corruption drives, they can be put in place immediately. They are doubly desirable when governance is weak and the need for institutions to handle oil revenues is immediate.

Reading the recent IMF documents on Iraq, one is struck by their lack of creativity. No innovative programs such as Palley's are put forth or even discussed. The program is pure fiscal austerity in a country where the real unemployment rate may approach 50 percent<sup>43</sup> and the performance of Iraq's infrastructure has fallen below pre-war levels.<sup>44</sup>

Where the Fund can be especially faulted is in its approach to the short run. What seems to be lacking in the IMF programs in Iraq is the acknowledgment that there might be some sort of linkage between their program and the insurgency. Are the IMF goals optimal in terms of extinguishing the insurgency, or might other strategies be more effective in this regard? Critical issues in this area are not even mentioned, let alone addressed in any systematic manner.

Given the unlikelihood that investors will flock to Iraq any time soon, is monetary and fiscal discipline at apparently any cost a worthwhile goal? Might not stepped-up government expenditures and job creation create a more stable short- to medium-term environment? It is as if the Fund were writing a program for an oil-rich transition country like Azerbaijan rather than a war-torn country with an ongoing insurgency.

One cannot help come away with the feeling that the Fund is under tremendous pressure (most likely from the United States and the UK) to become involved in Iraq. They moved ahead with the stand-by agree-

ment when they could have easily cited noncompliance with the terms of the EPCA as the reason for terminating their stay in Iraq. As it stands, they have very little leverage over the Iraqis, who can always blame some sort of crisis for suboptimal performance. Under these circumstances, an unconventional approach was certainly worth a try.

To make the most of their efforts in Iraq, the Fund would be well advised to listen carefully to Iraqi concerns. As one distinguished Iraqi economist has observed, "When I look at past IMF policy errors, I get frightened. Iraq stands no chance of success if the IMF makes policies like those it made in the past."<sup>45</sup>

An earlier essay, written in the summer of 2003 and before the insurgency started taking its toll, concluded that:

The reality is that Iraq is bankrupt. Even under fairly optimistic debt restructuring and oil revenue assumptions, it will simply not have the resources to implement a successful reconstruction and recovery program. While the country would likely be able to thrive under an international aid program as ambitious as the Marshall Plan that helped Europe recover from the ravages of World War II, there is no indication that donor countries are lining up to provide funds of this magnitude. No doubt significant amounts of aid funds, both humanitarian and development, will flow into Iraq, but these will be far short of the likely budgetary requirements needed to put Iraq's economy on a steady, self-sustained growth path.<sup>46</sup>

Sadly, this conclusion still holds today, with the IMF programs in Iraq doing little to change the basic situation. In fact, one can easily argue that the Fund has only added more stress to an already overburdened situation.

## Notes

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